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May 17, 1994

BY HAND DELIVERY

Mr. William Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, DC 20554

Re: Ex Parte Meeting -- MM Docket 92-266

Dear Mr. Caton:

On behalf of the Arts & Entertainment Network ("A&E"), this letter notifies the Commission that Nickolas Davatzes, President and CEO of A&E, Scott Richardson, Vice President for Public Affairs and Communications of A&E and Robert Corn-Revere met with Chairman Reed Hundt and his Legal Advisor Merrill Spiegel; Commissioner James H. Quello and his Legal Advisor Maureen O'Connell; and with Cable Services Bureau Chief Meredith Jones and Assistants William Johnson and Catherine Wallman to discuss the impact of the new rate regulations on the launch of new channels of programming. The discussion encompassed material described in the attached letter.

Two copies of this letter have been submitted to the Office of the Secretary, pursuant to Section 1.1206 of the Commission's rules.

Respectfully submitted,

Robert Corn-Revere

Robert Corn-Revere

Enclosure

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MAY 17 1994

ARTS & ENTERTAINMENT NETWORK

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

EX PARTE OR LATE FILED

May 11, 1994

NICKOLAS DAVATZES
President & CEO

Honorable James Quello
Commissioner
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Dear Commissioner Quello:

Thank you for making time to meet with me to discuss the creation of incentives to promote new and diverse cable programming services. We at the Arts & Entertainment Network ("A&E") have worked hard to develop a distinctive voice in the crowded cable television landscape. It is a voice that cares about quality programming and that fulfills that commitment daily by presenting a lineup featuring original biographies, mysteries and other special programming. We have been honored to receive more CableAce Awards than any other basic cable network, and we now reach more than 58 million U.S. cable households -- and all of this without the benefit of vertical integration.

Based on this proven track record, we are planning to launch The History Channel ("THC") late this fall or early winter. Independent research demonstrated to us that there is strong subscriber demand for historical documentaries, movies and miniseries, and we are planning to meet this consumer need. However, no matter how meritorious the concept or how strong the demand, no new service will succeed if it cannot obtain significant penetration among cable households. Unfortunately, industry reaction to the latest rate regulation orders has left the future of THC and other new services in doubt. Operators from across the country have informed us that they will cut back and significantly delay the introduction of new services, including THC.

We do not believe that this is a result the Commission intended. Among the findings that led Congress to adopt the Cable Communications and Consumer Protection Act of 1992 were the ideas that concentration in the cable industry created "barriers to entry for new programmers and a reduction in the number of media voices available to consumers" and that "[t]here is a substantial governmental and First Amendment interest in promoting a diversity of views provided through multiple technology media." 47 U.S.C. § 521(4), (6). Indeed, Congress specified that it was the policy of the Cable Act to:

- (1) promote the availability to the public of a diversity of views and information through cable television and other video distribution media;
- (2) rely on the marketplace, to the maximum extent feasible, to achieve that availability;

- (3) ensure that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems;
- (4) where cable systems are not subject to effective competition, ensure that consumer interests are protected in the receipt of cable service; and
- (5) ensure that cable television operators do not have undue market power vis-à-vis video programmers and consumers.

47 U.S.C. § 521(b).

The Commission sought to implement this congressional mandate in the "going forward" rules as part of the *Second Order on Reconsideration*, FCC 94-38 (released March 30, 1994). Indeed, that *Order* stated that under the going forward rules, "services that will be subject to regulation will be allowed to earn a competitive return." *Id.* at ¶ 58. The purpose, the Commission stated, was to permit program vendors [to] be able to charge market-driven prices for their services," to "stimulate investment by companies that supply programming," and to ensure that "consumer demand will determine the success or failure of new programming offerings." *Id.* at ¶ 62. The overriding regulatory purpose was to "allow cable operators to grow and develop new facilities and services, including new and innovative regulated programming services." *Id.* at ¶ 238.

A&E does not dispute the Commission's regulatory goal of encouraging new programming. We support it completely. But our experience has caused us to become quite concerned about the consequences of the latest rules. As we are working to bring The History Channel to subscribers, we are becoming convinced that the incentives the Commission intended to preserve are illusory. Cable operators from across the country have informed us that they must delay the addition of THC to their schedules, and many are unable to commit to the introduction of any new services. What we are hearing in the field is not a lobbying tactic. It is not a strategy that has been dreamed up by Washington lobbyists or trade associations. These reports come from the local system managers and reflect hard business realities. It is this reality that new programming services, like THC, must overcome. Consequently, we believe it is vital for the Commission to act to preserve the incentives it sought to create.

Although I believe it would be productive to discuss various aspects of the rules and the ways in which they interrelate, I will focus on aspects of the "going forward" methodology that relate to the creation of incentives.

First, it is vital that the percentage markup for external costs and upgrades be greater than 7.5 percent. Given the low per subscriber price of most cable services, a 7.5 percent markup provides little or no incentive to add services, fails to reflect normal business practices and ultimately will degrade the profitability of programming services. Moreover, it also is important to acknowledge that a markup based exclusively on a percentage of per-

subscriber prices discriminates against low-cost channels in favor of high-cost channels. Such a markup will encourage operators to add the most expensive channels they can find in order to maximize their return. For example, an operator who adds to a regulated tier a channel that costs \$3.00 per month would receive a markup of 22.5 cents, while the operator who adds a channel that costs 10 cents per subscriber per month would receive a markup of less than a penny. Another perverse effect of a percentage-based scheme is that it may encourage programming services to charge more (to the extent they can do so in a competitive programming market) and thereby drive up prices generally. The "variable markup" described in the following paragraph would help in certain respects, but the incentive to increase prices is inherent in any percentage-based scheme.

The Commission should consider an alternative method of providing programming incentives that would not be tied to a percentage of the licensing fee. Such an approach would promote the emergence of low-cost national channels and could be formulated to take into account the risk associated with launching new services. One possible plan would base the mark-up on a sliding scale (*e.g.*, the permitted charge for a new channel with 20 million subscribers or less would be the licensing fee plus 30 cents; the charge for a service with 20 to 30 million subscribers would be the licensing fee plus 25 cents; and the charge for a service with more than 30 million subscribers would be the licensing fee plus 20 cents). Also, where a given programming service fits on this scale could be adjusted periodically, perhaps every two years. Such an incentive structure should not apply to transaction-related channels, like home shopping, that are based on a different economic structure. Finally, if the Commission believes it is necessary, it might consider capping the number of channels that can be added in a given year in order to preclude possible "sticker shock" for cable subscribers.

There would be several advantages to this type of incentive plan. A specified markup figure should be easier to apply than a percentage rate, and it would not favor more expensive channels. Thus, operators would be freed to make channel choices based on their independent assessment of programming quality, not price. It also would permit programmers to hold down licensing fees. Adjusting the size of the incentive based on nationwide penetration simply recognizes the economic reality that services with higher penetration rates are less dependent on subscriber fees and can gain more revenue from advertising. Such an approach should nurture new programming services and ultimately would be better for subscribers.

The Commission should take care that any incentive structure does not encourage "churn," but instead allows for continued carriage of the channel that the subscribers value. Consequently, in addition to the incentive plan for adding new channels, the Commission should also permit a markup on external costs of a minimum of 15 percent to help prevent the reduction of operators' margins over time.

I do not mean to suggest that the amount of the markup is the only issue the Commission

Hon. James Quello
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needs to address. While it is vital that the Commission ensure that incentives for new programming are adequate, it is equally important that the Commission review its rules to eliminate any significant disincentives that may preclude the addition of new services. I am looking forward to having the opportunity to discuss these issues with you.

Please let me know if I may provide any additional information as the Commission as it reviews its rules.

Sincerely,

A handwritten signature in black ink, appearing to read "Nicholas D'Amico". The signature is fluid and cursive, with the first name "Nicholas" written in a larger, more prominent script than the last name "D'Amico".